## RESULTS OF OPERATIONS

As used in this section, references to increases and decreases, whether in terms of amounts or percentages, are made by comparison of the three and six months ended June 30, 2008 to the three and six months ended June 30, 2007.

**Revenues**

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| *(Canadian dollars in millions)* | **2008** | **2007** | **$ Change** | **% Change** | **2008** | **2007** | **$ Change** | **% Change** |
| Transmission | 293 | 315 | (22) | (7) | 597 | 642 | (45) | (7) |
| Distribution | 749 | 798 | (49) | (6) | 1,657 | 1,742 | (85) | (5) |
| Other | 13 | 7 | 6 | 86 | 23 | 14 | 9 | 64 |
| | 1,055 | 1,120 | (65) | (6) | 2,277 | 2,398 | (121) | (5) |
| Average Ontario 60-minute peak demand *(MW)*[1] | 20,786 | 22,414 | (1,628) | (7) | 21,531 | 22,947 | (1,416) | (6) |
| Distribution - units distributed to customers *(TWh)*[1] | 6.7 | 6.9 | (0.2) | (3) | 15.2 | 15.5 | (0.3) | (2) |

[1]System-related statistics are preliminary

The demand for electricity generally follows normal weather-related variations, and, therefore, our energy-related revenues, all other things being equal, will tend to be higher in the first and third quarters than in the second and fourth quarters.

***Transmission***

Transmission revenues predominantly consist of our transmission tariff, which is based on the monthly peak demand for electricity across our high-voltage network. The tariff is designed to recover revenues necessary to support a transmission system with sufficient capacity to accommodate the maximum expected demand, which is primarily influenced by weather and economic conditions. Transmission revenues also include minor amounts of ancillary revenues which are primarily attributable to maintenance services provided to generators and secondary use of our land rights-of-way.

Our transmission revenues were lower by $22 million, or 7%, in the second quarter, and by $45 million, or 7%, in the first six months compared to the same periods last year. Average monthly peak demand was lower in both periods, resulting in a reduction in transmission revenues of $23 million and $39 million, respectively.

In addition, as a result of the Ontario Energy Board's (OEB's) August 16, 2007 decision on our transmission rate application, our tariff revenues were lower than the comparable periods. In its decision, the OEB approved all of our work program expenditure requirements, but reduced our rate of return on equity from 9.88% to 8.35%. The January to August 2007 impact of the OEB's decision, which was effective January 1, 2007, was recognized at the decision date. A new regulatory liability, the Revenue Difference Deferral Account (RDDA), was recorded to reflect excess amounts previously recovered from customers. This account, together with the Transmission Earnings Sharing Mechanism (ESM) that was put in place by the OEB to equally share 2006 excess transmission earnings between customers and our shareholder, will be repaid to customers over the period November 1, 2007 to December 31, 2008. As a result of the OEB's decision to reduce our rate of return, we experienced reduced transmission revenues of $36 million in the second quarter and $76 million in the year-to-date period compared to the same periods last year. This impact was partially offset by adjustments to our earned revenue of $35 million in the second quarter and $68 million in the year-to-date period reflecting the fact that rates include a refund of amounts that were previously recorded as ESM and RDDA revenue reductions in 2006 and 2007 respectively. On May 30, 2008, we filed an application for a change in the uniform transmission rate, effective January 1, 2009, reflecting the completion of repayment of the ESM and the RDDA to customers.

We also experienced higher ancillary transmission revenues of approximately $2 million in the quarterly and year-to-date periods.

***Distribution***

Distribution revenues include our distribution tariff, which is based on OEB-approved rates, as well as amounts to recover the cost of purchased power used by our customers. Accordingly, distribution revenues are primarily influenced by our distribution rates, the amount of electricity we distribute, and the cost of purchased power. Distribution revenues also include a minor amount of ancillary distribution services revenues, such as fees related to the use of our poles by the telecommunications and cable television industries, and miscellaneous charges such as those for late payments.

Distribution revenues were lower by $49 million, or 6%, in the second quarter and by $85 million, or 5%, during the first six months compared to the same periods last year. These reductions primarily reflect lower purchased power costs of $39 million in the quarter and $84 million in the first six months, as described below under "Purchased Power." In addition, in the quarter, we completed the recovery of a significant regulatory asset. This resulted in decreased revenues of $5 million in the quarter and for the year-to-date. Lower energy consumption, resulting primarily from the milder winter and spring this year, reduced our distribution revenues by a further $3 million in the quarter and $1 million in the year-to-date period. Our revenues were also impacted by two earlier OEB decisions. The OEB's August 8, 2007 decision on its combined smart meter proceeding allowed us to begin recording revenue related to our installed smart meters. Our revenues related to our smart meter investments decreased by $3 million in the second quarter but increased by $3 million in the first six months of 2008 following recognition of previously deferred recoveries in the second quarter last year. Effective May 1, 2007, the OEB approved increases in distribution tariff rates for our subsidiaries, Hydro One Networks Inc. (Hydro One Networks) and Hydro One Brampton Inc., under an OEB incentive rate-setting mechanism. These increases, which support the maintenance and investment requirements of our distribution systems and which enable continued safe and reliable delivery of electricity to our customers throughout Ontario, resulted in higher distribution revenues of $1 million during the quarter and $2 million on a year-to-date basis.

We estimate that a 1% decrease in the forecast long-term Government of Canada bond yield used in the current OEB formula for determining our rate of return would reduce our Transmission Business' results of operations by approximately $20 million and our Distribution Business' results of operations by approximately $13 million.

***Other***

Other revenues increased by $6 million, or 86%, in the quarter and by $9 million, or 64%, in the year-to-date period as a result of higher revenues in our telecom business derived from a newly constructed dedicated optical network providing secure, high capacity connectivity across numerous health care locations in Ontario.

**Purchased Power**

Purchased power costs incurred by our Distribution Business represent the cost of electricity delivered to customers within our distribution service territory and consist of the wholesale commodity cost of energy, the Independent Electricity System Operator's (IESO's) wholesale market service charges, and transmission charges levied by the IESO. The commodity cost of energy for certain low-volume and designated customers is based on the OEB's Regulated Price Plan (RPP), which consists of a two-tiered pricing structure with threshold amounts adjusted twice annually. Customers who are not eligible for the RPP pay the market price for electricity, adjusted for the difference between market prices and the prices paid to generators under the *Electricity Restructuring Act, 2004*. A summary of the RPP impacting the reporting period is provided below.

| Summary of RPP | | | | |
|---|---|---|---|---|
| | Tier Threshold (kWh) | | Tier Rates (cents/kWh) | |
| Effective Date | Residential | Non-Residential | First Tier | Second Tier |
| November 1, 2006 | 1,000 | 750 | 5.5 | 6.4 |
| May 1, 2007 | 600 | 750 | 5.3 | 6.2 |
| November 1, 2007 | 1,000 | 750 | 5.0 | 5.9 |
| May 1, 2008 | 600 | 750 | 5.0 | 5.9 |

Purchased power costs decreased by $39 million, or 7%, to $483 million in the second quarter and by $84 million, or 7%, to $1,079 million during the first six months compared to last year. Our decreased purchased power costs were primarily due to changes in the OEB's RPP for residential and other eligible customers, which resulted in lower costs of $28 million in the quarter and $55 million in the year-to-date period, lower demand for electricity of $19 million in the quarter and $29 million in the year-to-date period, and the impact of lower charges levied by the IESO of $4 million in the quarter and $19 million in the year-to-date period. These lower IESO charges included lower transmission charges due to the OEB's August 16, 2007 transmission rate decision and lower wholesale market service charges. The impact of these decreases was partially offset by higher wholesale commodity prices of $12 million in the quarter and $19 million in the year-to-date period for customers who are not eligible for the RPP.

**Operation, Maintenance and Administration**

Our operation, maintenance and administration costs are comprised primarily of labour, material, equipment and purchased services in support of the operation and maintenance of the transmission and distribution systems. These costs also include property taxes and payments in lieu thereof on our transmission and distribution lines, stations and buildings.

Operation, maintenance and administration costs for each of our three business segments were as follows:

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| *(Canadian dollars in millions)* | 2008 | 2007 | $ Change | % Change | 2008 | 2007 | $ Change | % Change |
| Transmission | 105 | 107 | (2) | (2) | 202 | 206 | (4) | (2) |
| Distribution | 138 | 145 | (7) | (5) | 253 | 273 | (20) | (7) |
| Other | 12 | 7 | 5 | 71 | 21 | 14 | 7 | 50 |
| | 255 | 259 | (4) | (2) | 476 | 493 | (17) | (3) |

***Transmission***

Operation, maintenance and administration expenditures incurred to sustain our high-voltage transmission stations, lines and rights-of-way decreased by $2 million, or 2%, in the quarter and by $4 million, or 2%, on a year-to-date basis, compared to the same periods last year. Within our work programs, we continued our investments that support the safe and reliable operation of the transmission system. Our work program expenditures in the quarter remained relatively unchanged compared to the same period in 2007. For the year-to-date period, we experienced higher work program expenditures of $9 million primarily attributable to increased expenditures on our line maintenance programs, and increased forestry expenditures following an early start to our forestry program as a result of favourable weather conditions. The impact of these increases was partially offset by a decrease in expenditures within our station maintenance program. The increase in our work program expenditures for the year-to-date period was more than offset by a $13 million reduction in our expenditures incurred in support of the transmission system. This was primarily as a result of a one-time settlement credit associated with our transfer of pension assets to the Inergi LP (Inergi) pension plan following receipt of approval from the Financial Services Commission of Ontario in the first quarter of this year.

***Distribution***

Operation, maintenance and administration expenditures necessary to maintain our low-voltage distribution system decreased by $7 million, or 5%, in the second quarter and by $20 million, or 7%, on a year-to-date basis, relative to the comparative periods. Our work program expenditures were lower by $10 million in the quarter and by $13 million for the first six months compared to the prior year. These reductions in work program expenditures primarily resulted from the recognition, in the second quarter of 2007, of deferred smart meter expenditures originally incurred from 2005 to 2007. The expenditures were recognized as a result of the OEB's decision on August 8, 2007 regarding the combined smart meter proceeding. Such expenditures are now recognized as incurred. We also experienced lower work program expenditures for the year-to-date period resulting from lower conservation and demand management (CDM) program expenditures following meeting OEB program spending requirements associated with accessing our third phase Market Adjusted Rate of Return rates. We have participated in Ontario Power Authority (OPA)-funded CDM programs throughout the year-to-date period. These programs include the Electricity Retrofit Incentive Program, the Peaksaver Program, and the Great Refrigerator Roundup Program. These reductions in our expenditures for the first six months were partially offset by higher expenditures associated with

increased storm restoration and trouble call activity in the first quarter. We also experienced higher support expenditures of $3 million in the quarter, and lower expenditures in support of our distribution business of $7 million on a year to date basis, primarily as a result of the Inergi pension asset transfer settlement in the first quarter.

*Other*

Other operation, maintenance and administration costs increased by $5 million in the quarter and by $7 million year-to-date compared to the same periods last year. These increases were primarily attributable to higher expenditures to support increased revenues from our newly constructed dedicated optical network.

**Depreciation and Amortization**

Depreciation and amortization expense increased by $3 million, or 2%, to $132 million in the second quarter and by $8 million, or 3%, to $262 million in the first six months compared to the same periods last year. These increases were mainly attributable to increased depreciation expense related to the placement of new assets in service consistent with our ongoing capital work program. The impact of these increases was partially offset by lower amortization of regulatory assets due to the completion of recovery of a distribution-related deferral account in the quarter.

**Financing Charges**

Financing charges increased by $1 million, or 1%, to $75 million in the quarter and decreased by $3 million, or 2%, to $144 million on a year-to-date basis compared to the same periods last year. These changes in financing charges were due to an increase in interest capitalized on construction in progress, increased interest income resulting from a higher average level of investments, and a $6 million interest credit related to the Inergi pension asset transfer settlement in the first quarter which impacted the year-to-date period. The impact of these reductions was more than offset in the quarter, and partially offset in the six month period, by an increase in interest expense reflecting a higher average level of debt, partially offset by lower average interest rates.

**Provision for Payments in Lieu of Corporate Income Taxes**

The provision for payments in lieu of corporate income taxes decreased by $31 million, or 72%, to $12 million in the second quarter and decreased by $38 million, or 38%, to $61 million on a year-to-date basis, compared to the same periods last year. This decrease was primarily due to a reduction in the statutory tax rate from 36.12% to 33.50%, lower pre-tax income this year, and net temporary differences, including capital cost allowance in excess of depreciation.

**Net Income**

Net income of $98 million in the second quarter and $255 million on a year-to-date basis was higher by $5 million, or 5%, and higher by $13 million, or 5% respectively, compared to 2007 results. These increases in net income were primarily due to a reduction in our payments in lieu of corporate income taxes resulting from a lower statutory tax rate, combined with other net temporary differences. In the year-to-date period, our net income was further impacted by the pension asset transfer settlement with our service provider Inergi LP following approval from the Financial Services Commission of Ontario in the first quarter. The impact of these factors was partially offset in both the second quarter and year-to-date periods by lower transmission revenues resulting from the August 16, 2007 OEB rate decision and lower average monthly peak demands.

## QUARTERLY RESULTS OF OPERATIONS

The following table sets forth unaudited quarterly information for each of the nine quarters from September 30, 2006 through June 30, 2008. This information has been derived from our unaudited interim Consolidated Financial Statements which, in the opinion of our management, have been prepared on a basis consistent with the audited annual Consolidated Financial Statements and which include all adjustments, consisting only of normal recurring adjustments, necessary for fair presentation of our financial position and results of operations for those periods. These operating results are not necessarily indicative of results for any future period and should not be relied upon to predict our future performance.

| *(Canadian dollars in millions)* | 2008 | | | 2007 | | | 2006 | |
|---|---|---|---|---|---|---|---|---|
| Quarter ended | Jun. 30 | Mar. 31 | Dec. 31 | Sep. 30[2] | Jun. 30 | Mar. 31 | Dec. 31 | Sep. 30 |
| Total revenue[1] | 1,055 | 1,222 | 1,129 | 1,128 | 1,120 | 1,278 | 1,142 | 1,165 |
| Net income[1] | 98 | 157 | 90 | 67 | 93 | 149 | 101 | 103 |
| Net income to common shareholder[1] | 93 | 153 | 85 | 63 | 88 | 145 | 96 | 99 |

[1] The demand for electricity generally follows normal weather-related variations, and therefore our electricity-related revenues and profit, all other things being equal, would tend to be higher in the first and third quarters than in the second and fourth quarters.

[2] As a result of the OEB's August 16, 2007 decision on our transmission rate application that was effective January 1, 2007, revenues reflect a reduced revenue requirement based on the approved rate of return of 8.35%. Previously, the rate of return was 9.88%. Revenues in the third quarter of 2007 reflect a $38 million adjustment to revenues in respect of the period January 1, 2007 to August 16, 2007 and reflect the OEB's decision to reduce the rate of return and revise the capital structure of our Transmission Business.

## LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity and capital resources are funds generated from operations, debt capital market borrowings and bank financing. These resources will be used to satisfy our capital resource requirements, which continue to include capital expenditures, servicing and repayment of our debt, payments related to our outsourcing arrangements, investing activities, and dividends.

| **Summary of Sources and Uses of Cash** | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| *(Canadian dollars in millions)* | 2008 | 2007 | 2008 | 2007 |
| **Operating activities** | 255 | 249 | 487 | 543 |
| **Financing activities** | | | | |
| Long-term debt issued | - | - | 550 | 400 |
| Long-term debt retired | (540) | (282) | (540) | (282) |
| Short-term notes payable | 125 | 75 | 125 | 15 |
| Dividends paid | (73) | (73) | (114) | (180) |
| **Investing activities** | | | | |
| Capital expenditures | (303) | (303) | (514) | (490) |
| **Other financing and investing activities** | 3 | 4 | 11 | 8 |
| **Net change in cash and cash equivalents** | (533) | (330) | 5 | 14 |

### Operating Activities

Net cash from operating activities increased by $6 million, to $255 million in the second quarter, and decreased by $56 million to $487 million in the first six months compared to 2007 results. The year-to-date change was primarily due to changes in funding requirements relative to the comparative period, primarily in relation to accounts payable and accrued liabilities associated with our work programs as well as lower accounts receivable related to lower revenues.

### Financing Activities

Short-term liquidity is provided through funds from operations and our commercial paper program, under which we are authorized to issue up to $1 billion in short-term notes with a term to maturity of less than 365 days. At June 30, 2008, we had $125 million notes payable outstanding. Our commercial paper program is supported by a $1 billion committed revolving credit facility with a syndicate of banks maturing August 10, 2010. The short-term liquidity under this program and anticipated levels of funds from operations should be sufficient to fund our normal operating requirements. At June 30, 2008, we had $5,625 million in long-term debt outstanding, including the current portion. Our notes and debentures mature between 2009 and 2046. Long-term financing is provided by our access to the debt markets, primarily through our Medium-Term Note Program. The maximum authorized principal amount of medium-term notes issuable under this program is $2,500 million, of which $1,650 million is remaining and is currently available until July 2009.

| | Rating | |
|---|---|---|
| **Rating Agency** | **Short-term Debt** | **Long-term Debt** |
| DBRS Limited | R-1 (middle) | A (high) |
| Moody's Investors Service Inc. | Prime-1 | Aa3 |
| Standard & Poor's Rating Services Inc.[1] | A-1 | A+ |

[1] On June 3, 2008, Standard & Poor's Rating Services Inc. raised our long-term debt rating to A+ from A.

We have the customary covenants normally associated with long-term debt. Among other things, our long-term debt covenants limit our permissible debt as a percentage of our total capitalization, limit our ability to sell assets and impose a negative pledge provision, subject to customary exceptions. The credit agreement related to our $1 billion credit facility has no material adverse change clauses that could trigger default. However, the credit agreement requires that we provide notice to the lenders of any material adverse change within three business days of the occurrence. The agreement also provides limitations that debt cannot exceed 75% of total capitalization and that debt issued by our subsidiaries cannot exceed 10% of the total book value of our assets. We are in compliance with all of these covenants and limitations as at June 30, 2008.

We did not issue any long-term debt in the second quarters of 2008 and 2007, but repaid $540 million and $282 million in maturing long-term debt, respectively. For the second quarter of 2008, we increased our short-term notes outstanding by $125 million compared to an increase of $75 million for the same period in 2007.

During the first six months of 2008, we issued $550 million in long-term debt under our Medium-Term Note Program, repaid $540 million in maturing long-term debt, and increased our short-term notes by $125 million. In comparison, during the same period in 2007, we issued $400 million in long-term debt under our Medium-Term Note Program, repaid $282 million in maturing long-term debt and increased our short-term notes by $15 million.

In the second quarters of 2008 and 2007, we paid dividends to the Province of Ontario (the Province) in the amount of $73 million, consisting of $68 million in common dividends and $5 million in preferred dividends.

In the first six months of 2008, we paid dividends to the Province in the amount of $114 million, consisting of $105 million in common dividends and $9 million in preferred dividends. In the comparative period last year, we paid common dividends of $171 million and preferred dividends of $9 million.

Common dividends are declared at the sole discretion of our Board of Directors, and are recommended by management based on results of operations, financial condition, cash requirements, and other relevant factors such as industry practice and shareholder expectations. Common dividends pertaining to the quarterly financial results are generally declared and paid in the immediately following quarter.

**Investing Activities**

Cash used for investing activities primarily represents capital expenditures for each of our three business segments as follows:

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| *(Canadian dollars in millions)* | **2008** | **2007** | **$ Change** | **% Change** | **2008** | **2007** | **$ Change** | **% Change** |
| Transmission | 153 | 155 | (2) | (1) | 260 | 250 | 10 | 4 |
| Distribution | 146 | 138 | 8 | 6 | 248 | 229 | 19 | 8 |
| Other | 4 | 10 | (6) | (60) | 6 | 11 | (5) | (45) |
| | 303 | 303 | - | - | 514 | 490 | 24 | 5 |

***Transmission***

Transmission capital expenditures decreased by $2 million, or 1%, to $153 million in the second quarter, and increased by $10 million, or 4%, to $260 million in the first six months, compared to the same periods in 2007. Expenditures made to expand and reinforce our transmission system were $64 million in the quarter and $111 million for the first six months of the year, representing a $25 million reduction from both comparative periods. These reductions are primarily attributable to last year's substantial completion of work on our Whitby and London Talbot transformer stations, and our Downtown Toronto

Cable Project, lower expenditures on our Lambton Transformer Station this year, and a reduction in expenditures on several other large lines and stations development projects. These include: our new interconnection with Québec, which will increase access to emission-free hydroelectric power; our Cambridge Preston Transformer Station Project; and our Niagara Reinforcement Project, final completion of which continues to be delayed by the aboriginal land dispute in the Caledonia area. Discussions related to the Niagara Reinforcement Project continue between the aboriginal peoples involved and various government entities and we expect to complete this project when site access becomes available. The impact of these reductions in project expenditures was partially offset by load connection work at our Pleasant Transformer Station and by work on various new lines and stations development projects, including: our Essa Transformer Station to Stayner Transformer Station connection, which will improve the adequacy and reliability of supply to the Southern Georgian Bay region in recognition of the growing needs of our customers; our Bruce to Milton Transmission Reinforcement Project to connect redeveloped nuclear and wind generation sources in the Huron-Grey-Bruce area; and our Greater Toronto Area (GTA) West Transmission Reinforcement Project, which will increase capacity in the Western GTA to ensure supply reliability in the area.

Expenditures to sustain our existing transmission system were $66 million in the quarter and $105 million on a year-to-date basis, representing increases of $15 million and $13 million respectively, compared to the same periods last year. These increases were primarily due to expenditures related to the refurbishment and replacement of end-of-life equipment at our Claireville Transformer Station to improve current reliability and to meet growing demands. The impact of these increases was partially offset by lower expenditures on a number of small lines and stations improvement projects. Our other transmission capital expenditures were $23 million in the quarter and $44 million for the first six months, representing respective increases of $8 million and $22 million from the comparative periods. These increases were attributable to higher information technology expenditures primarily related to an entity-wide system improvement project to replace end-of-life systems and improve productivity combined with higher expenditures associated with information security enhancements at our Ontario Grid Control Centre.

***Distribution***

Distribution capital expenditures increased by $8 million, or 6%, to $146 million in the second quarter and by $19 million, or 8%, to $248 million for the first six months, compared to the same periods in 2007. Capital investments to expand and reinforce our distribution network were $83 million in the quarter and $124 million for the first six months of the year, representing increases of $12 million and $15 million over the comparable periods. These increases primarily reflect ongoing investments in our Smart Meter Program. During the quarter, we installed approximately 139,000 meters, bringing our cumulative program total of smart meters deployed to about 525,000. The impact of these increases was partially offset by lower expenditures for new customer connections and other small development projects.

Expenditures to sustain our distribution system of $50 million in the quarter and $95 million year-to-date, decreased by $6 million and $1 million, respectively, compared to the same periods last year. Lower expenditures for the second quarter were primarily a result of lower storm-recovery expenditures and lower planned end-of-life wood pole replacement expenditures within our lines work program. Our other distribution capital expenditures increased by $2 million to $13 million in the second quarter and by $5 million to $29 million in the first six months compared to the same periods in 2007. These increases were primarily attributable to higher information technology expenditures related to our entity-wide system improvement project.

***Other***

Other capital expenditures made to enhance our telecom infrastructure decreased by $6 million to $4 million in the quarter and by $5 million to $6 million in the year-to-date period, compared to the same periods last year. These reductions were largely due to the substantial completion of a dedicated optical network providing secure, high capacity connectivity across numerous healthcare locations in Ontario.

**Future Capital Expenditures**

Our capital expenditures in 2008 are budgeted at approximately $1.4 billion. The 2008 capital budgets for our transmission and distribution businesses are about $800 million and $600 million respectively. Our capital expenditures are expected to exceed $1.5 billion in both 2009 and 2010, primarily reflecting increasing investments to expand, refurbish or replace transmission infrastructure. Our overall investment levels reflect transmission infrastructure requirements consistent with government policy, OPA planning information as set out in its Integrated Power System Plan, local area supply requirements

and preventive and corrective maintenance requirements to manage aging assets. These investments will facilitate an adequate and reliable supply of electricity in the public interest. These investment levels also reflect the continued mass deployment of smart meters within our distribution businesses that began in 2007. An entity-wide system improvement project to replace end-of-life systems and increase productivity is also underway. Capital expenditures of our other business segment are budgeted at about $11 million in 2008, about half of the 2007 level, as a dedicated fibre optic network that was initiated in 2007 will be completed this year.

**Summary of Contractual Obligations and Other Commercial Commitments**

The following table presents a summary of our debt and other major contractual obligations as well as other major commercial commitments.

| *June 30, 2008 (Canadian dollars in millions)* | **Total** | **2008**[1] | **2009/2010** | **2011/2012** | **After 2012** |
|---|---|---|---|---|---|
| **Contractual Obligations** *(due by year)* | | | | | |
| Short-term notes payable | 125 | 125 | - | - | - |
| Long-term debt – principal repayments | 5,625 | - | 800 | 1,100 | 3,725 |
| Long-term debt – interest payments | 5,231 | 161 | 606 | 524 | 3,940 |
| Inergi LP outsourcing agreement[2] | 343 | 52 | 187 | 104 | - |
| Operating lease commitments | 15 | 3 | 8 | 2 | 2 |
| **Total Contractual Obligations** | 11,339 | 341 | 1,601 | 1,730 | 7,667 |
| | | | | | |
| **Other Commercial Commitments** *(by year of expiry)* | | | | | |
| Bank line[3] | 1,000 | - | 1,000 | - | - |
| Letters of credit[4] | 99 | 98 | 1 | - | - |
| Guarantees[4] | 325 | 325 | - | - | - |
| Pension[5] | 149 | 47 | 102 | - | - |
| **Total Other Commercial Commitments** | 1,573 | 470 | 1,103 | - | - |

[1] The amounts disclosed represent the balances due over the period July 1, 2008 to December 31, 2008.

[2] On March 1, 2002, Inergi began providing a range of services to us for a 10-year period, including information technology, customer care, supply chain and certain human resources and finance services.

[3] As a backstop to our commercial paper program, we have a $1 billion revolving standby credit facility with a syndicate of banks which matures in August 2010.

[4] We currently have bank letters of credit of $95 million outstanding relating to retirement compensation arrangements. The other $4 million included in letters of credit pertains to operating letters of credit and to surety bonds. We have also provided prudential support to the IESO on behalf of our subsidiaries, as required by the Market Rules, using parental guarantees of up to a maximum of $325 million. Although no letters of credit are required for prudential support, we would have to resume providing bank letters of credit if our credit rating deteriorated to below the "Aa" category.

[5] Contributions to the pension fund are made one month in arrears. Contributions for 2008 are based on an actuarial valuation filed in September 2007 and effective December 31, 2006. Our annual pension contributions for 2008 and 2009 will be about $94 million. Contributions beyond 2009 will be based on an actuarial valuation effective December 31, 2009 and will depend on future investment returns, changes in benefits or actuarial assumptions. Pension contributions beyond 2009 are not estimable at this time.

The amounts in the above table under long-term debt are not charged to our results of operations, but are reflected on our Balance Sheet and Statement of Cash Flows. Interest associated with this debt is recorded under financing charges on our Statement of Operations or in our capital programs, but these financing charges are not reflected in the above table. Payments in respect of operating leases and our outsourcing agreement with Inergi are recorded under operation, maintenance and administration costs on our Statement of Operations or in our capital programs.

## RELATED PARTY TRANSACTIONS

Related party transactions primarily consist of our transmission revenues received from, and our power purchases payments made to the IESO, which is a related party by virtue of its status as an agency of our shareholder, the Province. The year-over-year changes related to these amounts are described more fully in our discussion of our transmission revenues and purchased power costs. Other significant related party transactions include our dividends which are paid to the Province and our payments in lieu of corporate income taxes which are paid or payable to the Ontario Electricity Financial Corporation.

## STATUS OF OUR TRANSITION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

On February 13, 2008, the Canadian Accounting Standards Board confirmed that publicly accountable enterprises will be required to adopt IFRS in place of Canadian Generally Accepted Accounting Principles (GAAP) for interim and annual reporting purposes for fiscal years beginning on or after January 1, 2011. At this time, the impact on our future financial position and results of operations is not reasonably determinable or estimable.

We commenced our IFRS conversion project in 2007 and we have established a formal project governance structure. This structure includes a steering committee consisting of senior levels of management from finance, information technology, treasury and our operations organizations, among others. Regular reporting is provided to our senior executive management and to the Audit and Finance Committee of our Board of Directors. We have also engaged an external expert advisor.

Our project consists of four phases: diagnostic; design and planning; solution development; and implementation. We have completed the diagnostic phase, which involved a high level review of the major differences between current Canadian GAAP and IFRS. Currently, we have determined that the areas of accounting difference with the highest potential to impact our company are rate regulated accounting, accounting for fixed assets, payments in lieu of corporate income taxes, employee future benefits, as well as initial adoption of IFRS under the provisions of IFRS 1, *First-Time Adoption of IFRS*.

We are currently engaged in the design and planning and the solution development phases of our project. The design and planning phase involves working in issue-specific teams to focus on generating options and making recommendations in the identified areas. During the design and planning phase, we have established a staff communication plan, started to develop our staff training programs, and have begun to evaluate the impacts of the IFRS transition on other business activities. Work in the solution development phase has involved documentation of high impact areas identified, including an analysis of financial system impacts, the establishment of key milestones and ongoing discussions with our external auditors. The impact on disclosure controls and internal controls over financial reporting will also be determined.

The OEB has also begun its own IFRS project to determine the nature of any changes that should be made in regulatory accounting requirements in response to IFRS. On May 8, 2008, the OEB announced the creation of an IFRS Consultation which will provide an opportunity for Board staff to work with industry participants to identify transition issues and suggest how those issues might be addressed. We plan on participating in this process. On July 24, 2008, the OEB issued a letter to provide additional detail regarding the Consultation including scheduled meeting dates in August, September and October. We intend to closely monitor any International Financial Reporting Interpretations Committee (IFRIC) initiatives with the potential to impact rate regulated accounting under IFRS and will participate in any related processes, as appropriate.

## DISCLOSURE CONTROLS AND INTERNAL CONTROLS OVER FINANCIAL REPORTING

We are in the process of transitioning our major financial systems to an SAP enterprise-wide platform. A formal project governance structure is in place to ensure an effective transition of the information technology systems and business processes. The governance structure includes a steering committee consisting of senior levels of management which reports to senior executive management and the Business Transformation Committee of the Board of Directors.

On June 2, 2008, we implemented the first phase of the transition including the supply chain, asset, and work management modules within SAP. A portion of the Financial Accounting and Controlling modules were also implemented to facilitate financial reporting. This implementation included both new controls over Internal Controls over Financial Reporting (ICOFR) and replaced controls in the previous information technology system. Our process documentation has been updated and certain controls have been tested for purposes of determining whether they have been designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.

The second phase of the transition, which is planned for implementation in August, 2009, involves the replacement of existing finance, human resources and pay modules within SAP.

## RECENT DEVELOPMENTS

***Status of Applications to Construct Facilities***

On May 1, 2008, the OEB commenced the Section 92 leave-to-construct hearing for our Bruce to Milton Transmission Reinforcement project. The hearing concluded on June 11, 2008, and an OEB decision is anticipated in the third quarter of 2008. Environmental assessment approval is expected in early 2009.

***2008 Distribution Rate Application***

In 2007, we filed a cost of service application with the OEB for our Distribution Business operated through our subsidiary, Hydro One Networks. The oral hearing commenced on July 7, 2008 and final arguments will be submitted by the end of August 2008. Based on the OEB's processing guidelines, a decision is anticipated in the Fall of 2008.

***Uniform Transmission Rates***

On May 30, 2008, we submitted an application to the OEB to adjust Uniform Transmission Rates (UTRs) for our Transmission Business effective January 1, 2009. As of December 31, 2008, full repayment to customers of the ESM and RDDA will be complete. The anticipated corresponding impact will be an average increase of 9% of our revenue requirement allocation from UTRs to reflect the completion of repayment to customers of the amounts recorded in the ESM and the RDDA at the end of 2008. Based on the OEB's processing guidelines, we expect a decision in the fourth quarter of 2008.

***Credit Rating Upgrade***

On June 3, 2008, Standard & Poor's announced an increase in our long-term debt rating to "A+" from "A", and affirmed our "A-1" short-term rating. The rating action reflects Ontario's stable energy policy and the existence of consistent, independent regulation applied by the OEB.

## SELECTED FINANCIAL HIGHLIGHTS AND RATIOS

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| *(Canadian dollars in millions) (except as otherwise noted)* | **2008** | **2007** | **2008** | **2007** |
| Net income | 98 | 93 | 255 | 242 |
| Net cash from operating activities | 255 | 249 | 487 | 543 |
| Capital expenditures | 303 | 303 | 514 | 490 |
| Basic and fully diluted earnings per common share *(Canadian dollars)* | 937 | 888 | 2,461 | 2,334 |
| Earnings coverage ratio[1] | | | 2.59 | 2.77 |
| Net asset coverage on long-term debt[2] | | | 1.89 | 1.87 |
| Total debt to capitalization[3] | | | 53% | 53% |

[1]The earnings coverage ratio has been presented for the twelve months ended June 30, 2008 and June 30, 2007, respectively and has been calculated as the sum of net income, provision for payments in lieu of corporate income taxes and financing charges divided by the sum of financing charges, capitalized interest and cumulative preferred dividends.

[2]The net asset coverage on long-term debt ratio has been presented as at June 30, 2008 and December 31, 2007 and has been calculated as total assets minus total liabilities excluding long-term debt (including current portion) divided by long-term debt (including current portion).

[3]Total debt to capitalization ratio has been presented as at June 30, 2008 and December 31, 2007 and has been calculated as total debt divided by total debt plus total shareholder's equity.

## FORWARD-LOOKING STATEMENTS AND INFORMATION

Our oral and written public communications, including this document, often contain forward-looking statements that are based on current expectations, estimates, forecasts and projections about our business and the industry in which we operate and include beliefs and assumptions made by the management of our company. Such statements include, but are not limited to: expectations regarding developments in the statutory and operating framework for electricity distribution and transmission in Ontario including changes to codes, licenses, rates, rate orders, cost recovery, rates of return, rate structures and revenue requirements in both our transmission and distribution businesses and the timing of decisions from the OEB; statements regarding our future liquidity and capital resources; expectations regarding our financing activities; statements regarding future capital expenditures and our investment plans; expectations regarding the results of our projects and completion dates;

statements regarding contractual obligations and other commercial commitments; statements regarding future pension contributions; the estimated impact of changes in the forecast long-term Government of Canada bond yield (used in determining our regulated rate of return) on our results of operations; and statements about IFRS and our conversion to IFRS. Words such as "expect", "anticipate", "intend", "attempt", "may", "plan", "will", "believe", "seek", "estimate", "target", and "continue", and variations of such words and similar expressions, are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve assumptions and risks and uncertainties that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed, implied or forecasted in such forward-looking statements. We do not intend, and we disclaim any obligation to update any forward-looking statements, except as required by law.

These forward-looking statements are based on a variety of factors and assumptions including, but not limited to the following: no unforeseen changes in the legislative and operating framework for Ontario's electricity market; no unfavourable decisions from the OEB and other regulatory bodies concerning outstanding rate and other applications; no unforeseen changes in rate orders or rate structures for our distribution and transmission businesses; a stable regulatory environment; and no significant event occurring outside the ordinary course of business. These assumptions are based on information currently available to us, including information obtained from third party industry analysts. Actual results may differ materially from those predicted by such forward-looking statements. While we do not know what impact any of these differences may have, our business, results of operations, financial condition and our credit stability may be materially adversely affected. Factors that could cause actual results or outcomes to differ materially from the results expressed or implied by forward-looking statements include, among other things:

- the content of the final Integrated Power System Plan, as approved by the OEB;
- public opposition to and delays or denials of the requisite approvals and accommodations for our planned projects;
- regulatory decisions regarding our revenue requirements, cost recovery and rates;
- the risk that we are not able to arrange sufficient financing to repay maturing debt and to fund capital expenditures and other obligations;
- the risks associated with changes in the forecast long-term Government of Canada bond yield; and
- future interest rates, inflation, changes in benefits and changes in actuarial assumptions.

We caution the reader that the above list of factors is not exhaustive. Some of these and other factors are discussed in more detail under "Risk Management and Risk Factors" in the 2007 annual Management's Discussion and Analysis (MD&A). You should review the section entitled "Risk Management and Risk Factors" in detail.

This MD&A is dated as at August 13, 2008. Additional information about our company, including our Annual Information Form, is available on SEDAR at www.sedar.com.

## HYDRO ONE INC.
## CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (unaudited)

| *(Canadian dollars in millions)* | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| | **2008** | **2007** | **2008** | **2007** |
| **Revenues** | | | | |
| Transmission | 293 | 315 | 597 | 642 |
| Distribution | 749 | 798 | 1,657 | 1,742 |
| Other | 13 | 7 | 23 | 14 |
| | 1,055 | 1,120 | 2,277 | 2,398 |
| **Costs** | | | | |
| Purchased power | 483 | 522 | 1,079 | 1,163 |
| Operation, maintenance and administration *(Note 3)* | 255 | 259 | 476 | 493 |
| Depreciation and amortization | 132 | 129 | 262 | 254 |
| | 870 | 910 | 1,817 | 1,910 |
| **Income before financing charges and provision for payments in lieu of corporate income taxes** | 185 | 210 | 460 | 488 |
| Financing charges *(Note 3)* | 75 | 74 | 144 | 147 |
| **Income before provision for payments in lieu of corporate income taxes** | 110 | 136 | 316 | 341 |
| Provision for payments in lieu of corporate income taxes | 12 | 43 | 61 | 99 |
| **Net income** | 98 | 93 | 255 | 242 |
| Other comprehensive income | - | 1 | (1) | 1 |
| **Comprehensive income** | 98 | 94 | 254 | 243 |
| **Basic and fully diluted earnings per common share** *(Canadian dollars)* | 937 | 888 | 2,461 | 2,334 |

## CONSOLIDATED STATEMENTS OF RETAINED EARNINGS (unaudited)

| *(Canadian dollars in millions)* | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| | **2008** | **2007** | **2008** | **2007** |
| **Retained earnings, beginning of period** | 1,374 | 1,226 | 1,258 | 1,184 |
| Net income | 98 | 93 | 255 | 242 |
| Dividends *(Note 4)* | (73) | (73) | (114) | (180) |
| **Retained earnings, end of period** | 1,399 | 1,246 | 1,399 | 1,246 |

## CONSOLIDATED STATEMENTS OF ACCUMULATED OTHER COMPREHENSIVE INCOME (unaudited)

| *(Canadian dollars in millions)* | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| | **2008** | **2007** | **2008** | **2007** |
| **Accumulated other comprehensive income, beginning of period** | (10) | (12) | (9) | (12) |
| Other comprehensive income | - | 1 | (1) | 1 |
| **Accumulated other comprehensive income, end of period** | (10) | (11) | (10) | (11) |

*See accompanying notes to Consolidated Financial Statements.*

**HYDRO ONE INC.**
**CONSOLIDATED BALANCE SHEETS (unaudited)**

| *(Canadian dollars in millions)* | June 30, 2008 | December 31, 2007 |
|---|---|---|
| **Assets** | | |
| Current assets | | |
| Short-term investments | 10 | - |
| Accounts receivable (net of allowance for doubtful accounts) *(Note 2)* | 728 | 759 |
| Regulatory assets | 64 | 103 |
| Materials and supplies *(Note 2)* | 27 | 27 |
| Other | 8 | 17 |
| | 837 | 906 |
| Fixed assets | | |
| Fixed assets in service *(Note 2)* | 17,052 | 16,743 |
| Less: accumulated depreciation | 6,390 | 6,220 |
| | 10,662 | 10,523 |
| Construction in progress | 792 | 622 |
| Future use land, components and spares *(Note 2)* | 113 | 109 |
| | 11,567 | 11,254 |
| Long-term assets | | |
| Deferred pension asset | 410 | 380 |
| Regulatory assets | 101 | 110 |
| Goodwill | 133 | 133 |
| Long-term accounts receivable and other assets *(Note 2)* | 8 | 7 |
| | 652 | 630 |
| **Total assets** | 13,056 | 12,790 |
| | | |
| **Liabilities** | | |
| Current liabilities | | |
| Bank indebtedness | 17 | 12 |
| Accounts payable and accrued charges | 660 | 731 |
| Regulatory liabilities | 62 | 114 |
| Accrued interest | 60 | 55 |
| Short-term notes payable | 125 | - |
| Long-term debt payable within one year | 400 | 540 |
| | 1,324 | 1,452 |
| Long-term debt *(Note 5)* | 5,221 | 5,063 |
| | | |
| Other long-term liabilities | | |
| Regulatory liabilities | 543 | 469 |
| Employee future benefits other than pension | 882 | 855 |
| Environmental liabilities | 48 | 52 |
| Long-term accounts payable and other liabilities | 12 | 13 |
| | 1,485 | 1,389 |
| **Total liabilities** | 8,030 | 7,904 |
| | | |
| **Shareholder's equity** | | |
| Preferred shares (authorized: unlimited; issued: 12,920,000) | 323 | 323 |
| Common shares (authorized: unlimited; issued: 100,000) | 3,314 | 3,314 |
| Total share capital | 3,637 | 3,637 |
| Retained earnings | 1,399 | 1,258 |
| Accumulated other comprehensive income | (10) | (9) |
| Total retained earnings and accumulated other comprehensive income | 1,389 | 1,249 |
| **Total shareholder's equity** | 5,026 | 4,886 |
| **Total liabilities and shareholder's equity** | 13,056 | 12,790 |

*See accompanying notes to Consolidated Financial Statements.*

**HYDRO ONE INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)**

| *(Canadian dollars in millions)* | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| | **2008** | **2007** | **2008** | **2007** |
| **Operating activities** | | | | |
| Net income | 98 | 93 | 255 | 242 |
| Adjustments for non-cash items: | | | | |
| Depreciation and amortization (net of removal costs) | 118 | 116 | 241 | 231 |
| Revenue difference deferral account | (18) | - | (38) | - |
| Retail settlement variance accounts | 14 | - | 42 | 16 |
| Other regulatory asset and liability accounts | (8) | 7 | (12) | 18 |
| Amortization of discount | 1 | 3 | 1 | 6 |
| | 205 | 219 | 489 | 513 |
| Changes in non-cash balances related to operations | 50 | 30 | (2) | 30 |
| **Net cash from operating activities** | 255 | 249 | 487 | 543 |
| **Financing activities** | | | | |
| Long-term debt issued | - | - | 550 | 400 |
| Long-term debt retired | (540) | (282) | (540) | (282) |
| Short-term notes payable | 125 | 75 | 125 | 15 |
| Dividends paid | (73) | (73) | (114) | (180) |
| Other | 1 | - | 7 | (1) |
| **Net cash (used in) from financing activities** | (487) | (280) | 28 | (48) |
| **Investing activities** | | | | |
| Capital expenditures | (303) | (303) | (514) | (490) |
| Other assets | 2 | 4 | 4 | 9 |
| **Net cash used in investing activities** | (301) | (299) | (510) | (481) |
| **Net change in cash and cash equivalents** | (533) | (330) | 5 | 14 |
| Cash and cash equivalents, beginning of period | 526 | 315 | (12) | (29) |
| **Cash and cash equivalents, end of period** | (7) | (15) | (7) | (15) |

*See accompanying notes to Consolidated Financial Statements.*

## 1. BASIS OF PRESENTATION

These interim Consolidated Financial Statements do not conform in all respects to the disclosure requirements of Canadian generally accepted accounting principles for annual financial statements and should, therefore, be read in conjunction with the annual Consolidated Financial Statements of Hydro One Inc. (Hydro One or the Company) for the year ending December 31, 2007 which include information necessary or useful to understanding the Company's business and financial statement presentation. In particular, the Company's significant accounting policies and practices are presented as Note 2 to the annual Consolidated Financial Statements, and have been consistently applied in the preparation of these interim Consolidated Financial Statements, except as described below in Note 2.

The demand for electricity generally follows normal weather-related variations, and therefore the Company's energy-related revenues, all other things being equal, will tend to be higher in the first and third quarters than in the second and fourth quarters.

## 2. ACCOUNTING CHANGES

***Change in Accounting Policy – Inventory***

Effective January 1, 2008, the Company retrospectively adopted Canadian Institute of Chartered Accountants' (CICA) Handbook Section 3031, *Inventories*, with reclassification of comparative prior period amounts. This new section requires that certain major spare parts and standby equipment be reclassified from inventory to fixed assets. The new Handbook section also allows previously recorded impairment losses taken on inventory to be reversed if there is evidence that the net realizable value has subsequently recovered.

The Company already includes certain major standby equipment as in-service fixed assets and depreciates these assets over their useful lives. Upon adoption of the new section in the first quarter of 2008, the Company reclassified approximately $42 million (2007 - $40 million) in asset components and equipment previously classified as materials and supplies inventory. Concurrent with the above reclassification, the Company also reclassified future use land with a carrying value of approximately $69 million (2007 - $69 million) from "fixed assets in service" to "future use land, components and spares." Future use land, components and spares are not depreciated until they are transferred to active capital projects and those projects are placed in-service.

***Change in Capital Disclosures and Financial Instrument Disclosures and Presentation***

Effective January 1, 2008, the Company adopted three new accounting standards comprising CICA Handbook Sections 1535, *Capital Disclosures*; 3862, *Financial Instruments Disclosures*; and 3863, *Financial Instruments Presentation*. The adoption of these new standards required the disclosure of qualitative and quantitative information about the Company's capital and how it is managed, and an increased emphasis on disclosure about the risks associated with recognized and unrecognized financial instruments. The adoption of the new standard on presentation carried forward unchanged the presentation requirements from Section 3861, *Financial Instruments Disclosure and Presentation*, and therefore adoption of this new standard did not have any impact on the interim Consolidated Financial Statements.

***Capital Disclosures***

The Company's objectives with respect to its capital structure are to maintain effective access to capital on a long-term basis at reasonable rates, and to deliver appropriate financial returns. In order to ensure ongoing effective access to capital, the Company targets to maintain an "A" category long-term credit rating.

The Company considers its capital structure to consist of shareholder's equity, short-term and long-term debt, and cash and cash equivalents. The Company's capital structure as at June 30, 2008 and December 31, 2007 was as follows:

| *(Canadian dollars in millions)* | June 30, 2008 | December 31, 2007 |
|---|---|---|
| Short-term notes payable | 125 | - |
| Long-term debt payable within one year | 400 | 540 |
| Less: Cash and cash equivalents | (7) | (12) |
| | 532 | 552 |
| Long-term debt | 5,221 | 5,063 |
| Preferred Shares | 323 | 323 |
| Common Shares | 3,314 | 3,314 |
| Retained Earnings | 1,399 | 1,258 |
| | 5,036 | 4,895 |
| **Total Capital** | 10,789 | 10,510 |

For the purposes of this table and the Consolidated Statements of Cash Flows, "cash and cash equivalents" refers to the Consolidated Balance Sheet items "short-term investments" and "bank indebtedness."

The Company has customary covenants typically associated with long-term debt. Among other things, Hydro One's long-term debt and credit facility covenants limit the permissible debt to 75% of the Company's total capitalization, limit the ability to sell assets and impose a negative pledge provision, subject to customary exceptions. Hydro One is in compliance with all of these covenants and limitations.

***Financial Instrument Disclosures***

Exposure to market risk, credit risk and liquidity risk arises in the normal course of the Company's business.

*Market Risk*

Market risk refers primarily to the risk of loss that results from changes in commodity prices, foreign exchange rates and interest rates. The Company does not have commodity risk and its foreign exchange risk is currently insignificant, although the Company could in future decide to issue foreign currency denominated debt. Hydro One is exposed to fluctuations in interest rates as the regulated rate of return for the Company's distribution and transmission businesses is derived using a formulaic approach which is in part based on the forecast for long-term Government of Canada bond yields. The Company estimates that a 1% decrease in the forecast long-term Government of Canada bond yield used in the current OEB formula for determining the Company's rate of return would reduce its Transmission Business' results of operations by approximately $20 million and its Distribution Business' results of operations by approximately $13 million.

*Credit Risk*

Financial assets create credit risk that a counter-party will fail to discharge an obligation, causing a financial loss. The Company's revenue is earned from a broad base of customers. As a result, Hydro One did not earn a significant amount of revenue from any individual customer. As at June 30, 2008, there were no significant balances of accounts receivable due from any single customer.

In the quarter, the Company's provision for bad debts increased by $1 million to $23 million as a result of adjustments and write-offs determined on the basis of a review of overdue accounts, taking into consideration historical experience. As at June 30, 2008, approximately 5% of the Company's accounts receivable were aged more than 60 days.

Hydro One manages its counter-party credit risk through various techniques including, entering into transactions with highly rated counter-parties, limiting total exposure levels with individual counterparties consistent with the Company's Board-approved Credit Risk Policy, entering into master agreements which enable net settlement and the contractual right of offset, and monitoring the financial condition of counterparties. Short-term investments held as at June 30, 2008, were consistent with the credit exposure limits specified under the Company's Credit Risk Policy. The Company's credit risk for short-term investments and accounts receivable is limited to the carrying amount on the Consolidated Balance Sheet.

The Company uses derivative financial instruments to manage interest rate risk. Derivative financial instruments result in exposure to credit risk since there is a risk of counter-party default. As at June 30, 2008, the only derivative instrument held by Hydro One was a fixed-to-floating interest rate swap agreement to convert the 4.08% coupon maturing March 3, 2011 into variable rate debt. The exposure to credit risk from this derivative instrument as at June 30, 2008 was insignificant.

*Liquidity Risk*

Liquidity risk refers to the Company's ability to meet its financial obligations as they come due. Short-term liquidity is provided through cash and cash equivalents on hand, funds from operations, and the Company's Commercial Paper Program, under which it is authorized to issue up to $1 billion in short-term notes with a term to maturity of less than 365 days. The Commercial Paper Program is supported by a $1 billion committed revolving credit facility with a syndicate of banks maturing in August 2010. The short-term liquidity available to the Company should be sufficient to fund normal operating requirements.

As at June 30, 2008, accounts payable and accrued liabilities in the amount of $660 million and short-term notes payable in the amount of $125 million, are expected to be settled in cash at their carrying amounts within the next year. Short-term notes payable represent promissory notes with varying maturities not exceeding 365 days. Long-term debt maturing over the next twelve months is $400 million. Interest payments over the next twelve months on our outstanding debt amount to $322 million.

As at June 30, 2008, Hydro One has issued long-term debt in the amount of $5,625 million and the Company is required to make interest payments in the amount of $5,231 million. Principal outstanding and interest payments are summarized by the number of years to maturity in the following table:

| Years to Maturity | Principal Outstanding on Notes and Debentures *(Canadian dollars in millions)* | Interest Payments *(Canadian dollars in millions)* |
|---|---|---|
| 1 – 5 years | 1,900 | 1,399 |
| 6 – 10 years | 1,050 | 1,026 |
| Over 10 years | 2,675 | 2,806 |
| **Total** | 5,625 | 5,231 |

***Emerging Accounting Changes – Rate Regulated Operations***

In August 2007, the Canadian Accounting Standards Board (AcSB) issued a decision, effective January 1, 2009, to withdraw the temporary exemption in CICA Handbook Section 1100, *Generally Accepted Accounting Principles*, which permits the recognition and measurement of assets and liabilities arising from rate regulation. Further, CICA Handbook Section 3465, *Income Taxes*, was amended to require the recognition of future income tax liabilities and assets for regulated enterprises that were previously not subject these provisions. Consequently, the Company will be required to reflect on its Consolidated Balance Sheet, the effect of applying the liability method when accounting for payments in lieu of corporate income taxes and a corresponding regulatory asset. The Company is currently assessing the impact of the AcSB's decision on its Consolidated Balance Sheet.

## 3. PENSION ASSET TRANSFER

Effective March 1, 2002, Hydro One began receiving a range of services from Inergi LP, including information technology, customer care, supply chain and certain human resources and financial services. In connection with this agreement, the Company transferred approximately 770 regular employees to Inergi LP. On March 10, 2008, the Company was granted consent from the Financial Services Commission of Ontario to transfer pension assets and related pension liabilities for affected employees from the Hydro One Pension Plan to the Inergi LP Pension Plan. Under the agreement, the Company recognized a settlement of $21 million in its results of operations for the first quarter, inclusive of a related interest credit of $6 million. The pension asset transfer took place in the second quarter.

## 4. DIVIDENDS

During the three months ended June 30, 2008, preferred dividends in the amount of $5 million (2007 - $5 million) and common dividends in the amount of $68 million (2007 - $68 million) were declared. During the six months ended June 30, 2008, preferred dividends in the amount of $9 million (2007 - $9 million) and common dividends in the amount of $105 million (2007 - $171 million) were declared.

## 5. LONG-TERM DEBT

In January 2008, the Company entered into a forward starting interest rate swap agreement to hedge against the effect of future interest rate movements on long-term fixed rate borrowing requirements. This transaction had a notional amount of $60 million and was used to lock in the interest rate of a forecasted debt issuance which took place on March 3, 2008. The transaction was accounted for as a cash flow hedge of a forecasted transaction.

On March 3, 2008, Hydro One issued additional notes under the Company's Medium-Term Note Program. The new issue was comprised of medium term notes with a principal amount of $250 million having a 3-year term with a coupon rate of 4.08%. The notes are due March 3, 2011. On the same date the Company made an additional offering of 5.18% medium-term notes that originally settled October 18, 2007. The issue was comprised of medium-term notes with a principal amount of $300 million having a 9.6 year term with a coupon rate of 5.18%. The notes are due October 18, 2017. In relation to this debt issuance, on March 3, 2008, the Company terminated the three forward starting interest rate swaps entered into in the last quarter of 2007 and the first quarter of 2008 that had a total notional principal amount of $200 million. The transactions had been accounted for as cash flow hedges of a forecasted debt issue for the purpose of fixing the interest rate for the debt issuance. The net loss realized on terminating the swaps was $1.2 million which has been recorded in Other Comprehensive Income and will be amortized to financing charges over the term of the related debt.

In the second quarter, Hydro One provided notice that it would not extend the maturity date of its $40 million extendible step-up note that matured May 15, 2008. The associated pay-floating interest rate swap also matured on May 15, 2008.

Also during the quarter, the Company entered into a $250 million notional principal amount fixed-to-floating interest rate swap to convert Hydro One's 4.08% coupon note maturing March 3, 2011 into variable rate debt. This transaction is being accounted for as a fair value hedge.

## 6. EMPLOYEE FUTURE BENEFITS

Total benefit costs are as follows:

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| *(Canadian dollars in millions)* | **2008** | **2007** | **2008** | **2007** |
| **Pension** | | | | |
| Net periodic benefit cost | 10 | 25 | 20 | 50 |
| Pension fund contribution | 25 | 26 | 50 | 51 |
| Less: Portion attributable to labour and capitalized as part of the cost of fixed assets | 9 | 10 | 19 | 20 |
| Charged to results of operations | 16 | 16 | 31 | 31 |
| **Employee Future Benefits Other than Pension** | | | | |
| Net periodic benefit cost | 22 | 26 | 45 | 53 |
| Less: Portion attributable to labour and capitalized as part of the cost of fixed assets | 9 | 11 | 18 | 21 |
| Charged to results of operations | 13 | 15 | 27 | 32 |

## 7. SEGMENTED REPORTING

Hydro One has three reportable segments:

- The Transmission Business, which comprises the core business of providing transportation and connection services, is responsible for transmitting electricity throughout the Ontario electricity grid;
- The Distribution Business, which comprises the core business of delivering and selling electricity to customers; and
- An "other" segment primarily consisting of a telecommunications business.

The designation of segments has been based on a combination of regulatory status and the nature of the products and services provided. Segment information on the above basis is as follows:

| *Three months ended June 30 (Canadian dollars in millions)* | **Transmission** | **Distribution** | **Other** | **Consolidated** |
|---|---|---|---|---|
| **2008** | | | | |
| **Segment profit** | | | | |
| Revenues | 293 | 749 | 13 | 1,055 |
| Purchased power | - | 483 | - | 483 |
| Operation, maintenance and administration | 105 | 138 | 12 | 255 |
| Depreciation and amortization | 62 | 68 | 2 | 132 |
| **Income (loss) before financing charges and provision for payments in lieu of corporate income taxes** | 126 | 60 | (1) | 185 |
| Financing charges | | | | 75 |
| **Income before provision for payments in lieu of corporate income taxes** | | | | 110 |
| **Capital expenditures** | 153 | 146 | 4 | 303 |
| **2007** | | | | |
| **Segment profit** | | | | |
| Revenues | 315 | 798 | 7 | 1,120 |
| Purchased power | - | 522 | - | 522 |
| Operation, maintenance and administration | 107 | 145 | 7 | 259 |
| Depreciation and amortization | 60 | 67 | 2 | 129 |
| **Income (loss) before financing charges and provision for payments in lieu of corporate income taxes** | 148 | 64 | (2) | 210 |
| Financing charges | | | | 74 |
| **Income before provision for payments in lieu of corporate income taxes** | | | | 136 |
| **Capital expenditures** | 155 | 138 | 10 | 303 |

| *Six months ended June 30 (Canadian dollars in millions)* | **Transmission** | **Distribution** | **Other** | **Consolidated** |
|---|---|---|---|---|
| **2008** | | | | |
| **Segment profit** | | | | |
| Revenues | 597 | 1,657 | 23 | 2,277 |
| Purchased power | - | 1,079 | - | 1,079 |
| Operation, maintenance and administration | 202 | 253 | 21 | 476 |
| Depreciation and amortization | 121 | 138 | 3 | 262 |
| **Income (loss) before financing charges and provision for payments in lieu of corporate income taxes** | 274 | 187 | (1) | 460 |
| Financing charges | | | | 144 |
| **Income before provision for payments in lieu of corporate income taxes** | | | | 316 |
| **Capital expenditures** | 260 | 248 | 6 | 514 |

| *Six months ended June 30 (Canadian dollars in millions)* | Transmission | Distribution | Other | Consolidated |
|---|---|---|---|---|
| **2007** | | | | |
| **Segment profit** | | | | |
| Revenues | 642 | 1,742 | 14 | 2,398 |
| Purchased power | - | 1,163 | - | 1,163 |
| Operation, maintenance and administration | 206 | 273 | 14 | 493 |
| Depreciation and amortization | 120 | 131 | 3 | 254 |
| **Income (loss) before financing charges and provision for payments in lieu of corporate income taxes** | 316 | 175 | (3) | 488 |
| Financing charges | | | | 147 |
| **Income before provision for payments in lieu of corporate income taxes** | | | | 341 |
| **Capital expenditures** | 250 | 229 | 11 | 490 |

| *(Canadian dollars in millions)* | June 30, 2008 | December 31, 2007 |
|---|---|---|
| **Total assets** | | |
| Transmission | 7,438 | 7,273 |
| Distribution | 5,497 | 5,411 |
| Other | 121 | 106 |
| | 13,056 | 12,790 |

All revenues, costs and assets, as the case may be, are earned, incurred or held in Canada.

## 8. COMPARATIVE FIGURES

The comparative unaudited interim Consolidated Financial Statements have been reclassified from statements previously presented to conform to the presentation of the June 30, 2008 unaudited interim Consolidated Financial Statements.